



Irving Trust

Economic Outlook

Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research &
Planning Division

September 1986

Both the bond market and the stock market seem to have acquired a case of the jitters. The outlook for the economy has become particularly muddled. Earlier this year the possibilities were well defined: The economy would either improve in response to past declines in interest rates and the dollar, or it would plod along with unsatisfactory real growth, which would cause the Federal Reserve to push interest rates (and the dollar) lower. The latter case was the one that materialized.

Today the concerns seem to be moving in opposite directions. The skittishness in the bond market is a reaction to recent signs of improvement in the economy, such as widespread gains in manufacturing employment in August and the bottoming out of the rig count. In addition, oil prices and prices of certain other commodities have risen from their recent lows, while rapid growth in the broader monetary aggregates M2 and M3 makes it difficult for the Fed to justify additional stimulus. At the other end of the spectrum, some are concerned that the economy is still fundamentally weak but that the Fed may not act decisively enough to lift it out of the doldrums.

The current round of rock-bottom incentive financing for autos will make it especially difficult to get a true reading on the economy's momentum since it will likely produce a roller-coaster pattern of auto sales. It seems to us that the declines in interest rates and the dollar should eventually lead to an improvement in economic growth, although trouble spots will remain quite visible. Because of the loss of the investment tax credit, pending tax reform presents special risks for capital spending next year. In addition, the corporate tax rate will decline from the current rate of 46% to a blended rate of only 40% in 1987 before declining to 34% in 1988. Real GNP is expected to rise 2.9% from the fourth quarter of 1985 to the fourth quarter of 1986 and 3.5% next year.

Low inflation this year has given the Fed considerable leeway to reduce interest rates. In the summer of 1984, just before interest rates began to decline, the Federal funds rate was about 11.5%. Since the year-over-year increase in the consumer price index at that time was 4.2%, the Fed had ample room to push rates lower. Today, with the Federal funds rate near 5.75% and the comparable increase in the CPI at 1.6%, the Fed would seem to have sufficient maneuvering room to ease further. Excluding food and energy, however, the latest year-over-year increase in consumer prices is 4.1%. At this time in 1984, the comparable increase was 5.1%. The underlying inflation rate has abated, but only by a percentage point.

The substantial dollar depreciation thus far is bound to produce visible upward pressures on inflation. These pressures will be partially offset by continuing high levels of imports from low-wage countries, such as South Korea and Taiwan, whose currencies to date have hardly moved against the dollar. Now that oil prices have risen from their lows, it seems reasonable to expect the inflation rate to approach 4%-4.5% at some point in 1987. Worldwide excess capacity for many industrial and agricultural commodities, however, has been an important factor in keeping inflation low during the last few years and will likely continue to do so during the next several years as well.

Bernard Schoenfeld



Economic Forecast

Percent Changes at Annual Rates

	Actual		Forecast								Actual	Forecast	
			1986				1987				1984-	1985-	1986-
	I	II	III	IV	I	II	III	IV	1985	1986	1987		
Gross National Product	6.2	3.0	6.6	8.4	7.8	8.4	3.3	7.2	6.2	5.7	7.2		
Real GNP	3.8	0.6	3.1	4.3	4.0	4.0	3.7	2.5	2.7	2.7	3.6		
GNP Price Deflator	2.5	2.5	3.3	3.9	3.7	4.3	4.4	4.6	3.4	2.9	3.5		

	Actual		Forecast		Actual		Forecast	
	1986:II		1986:III		1984-1985		1985-1986	1986-1987
Consumer Spending	5.7%		9.5%		7.1%		6.4%	6.7%
Durable Goods	17.6		20.3		8.5		5.8	4.2
Nondurable Goods	-0.3		5.6		4.0		3.8	6.1
Services	6.7		9.3		8.9		8.3	7.7
Business Capital Spending	-2.3		3.4		10.0		0.5	3.1
Structures	-32.3		-6.1		11.1		-7.7	-2.3
Equipment	16.0		7.9		9.4		4.7	5.6
Residential Investment	21.9		16.5		5.7		13.8	9.0

	1985	1986	1987
Change in Inventories	\$12.5b.	\$-4.5b.	\$11.1b.
Net Exports of Goods and Services	\$-100.2b.	\$-109.2b.	\$-78.9b.

	1984-1985	1985-1986	1986-1987
Government Purchases	11.6%	8.9%	11.2%
Federal	13.4	12.9	13.7
Defense	18.6	13.8	10.4
Other	-0.9	10.2	24.3
State & Local	10.4	6.1	9.3

Corporate Profits Before Tax	8.5*	4.1*	-5.3	4.1	8.5
Corporate Profits After Tax	11.1*	8.7*	-6.4	7.1	4.0
Plant and Equipment Expenditures	-0.5	1.2	9.2	-1.9	1.0
Real Final Sales*	3.8	4.9	4.2	2.6	3.3
Real Disposable Personal Income	7.4	3.3	2.3	4.1	3.7

Economic Indicators	Recent Data			Actual 1984-1985	Forecast	
	June	July	Aug.		1985-1986	1986-1987
Consumer Price Index**	6.0%	0.0%	n.a.	3.7%	2.0%	4.0%
Producer Price Index for Finished Goods**	0.0	-4.8	3.6%	2.1	-1.4	3.7
Industrial Production	-0.3	-0.1	n.a.	2.2	0.3	2.0
Retail Sales**	0.2	0.3	0.8	6.5	4.4	5.0
Auto Sales (millions of units, a.r.)	11.1	10.7	12.7	11.1	11.2	10.4
Housing Starts (millions of units, a.r.)	1.85	1.82	n.a.	1.74	1.88	1.70
Unemployment Rate	7.1%	6.9%	6.8%	7.2%	6.9%	6.5%
Merchandise Trade Deficit (a.r.)	\$170.0b.	\$216.4b.	n.a.	\$148.5b.	\$170.0b.	\$145.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

September 12, 1986

*GNP less change in inventories, both in real terms.

**Monthly percent changes are not annualized.

*Year-over-year percent changes.

**Annual percent changes are December to December (not seasonally adjusted).

\$b. = billions a.r. = annual rate F = Forecast